No. 73-641

In the Supreme Court of the United States

OCTOBER TERM, 1973

EDWIN A. SNOW AND HELEN B. SNOW, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 13-34) are reported at 58 T.C. 585. The opinion of the court of appeals (Pet. App. 35-44) is reported at 482 F.2d 1029.

JURISDICTION

The judgment of the court of appeals was entered on July 17, 1973 (I-A. 1).[1] The petition for a writ of certiorari was filed on October 12, 1973, and was granted on January 7, 1974 (I-A. 104). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether both courts below correctly held that petitioner could not deduct his pro rata share of expenditures incurred by a partnership for the development of an invention as research or experimental expenditures under Section 174 of the Internal Revenue Code of 1954, because they were not incurred in connection with a trade or business.

STATUTE INVOLVED

Section 174 of the Internal Revenue Code of 1954 is set forth in Appendix A, *infra*, pp. 40-42.

STATEMENT

Petitioner[2] is an officer of Procter & Gamble Company, where he has been employed since 1933. His work for that corporation was initially in ad-

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[1] "A." references are to the record appendix which is separately bound in two volumes. References "I" and "II" are to the volume of the record appendix.

[2] References to petitioner are to Edwin A. Snow; Helen B. Snow is a party solely by reason of having filed a joint return with her husband for 1966, the year at issue.

vertising and marketing. Subsequently, petitioner's employment duties were in management, and in 1966, he became executive vice-president of Procter & Gamble and a member of its board of directors. Petitioner never had any training in engineering nor had he ever applied for a patent (Pet. App. 14).

Since 1942, petitioner has known David H. Trott, a fellow Procter & Gamble employee, who also worked in advertising, marketing, and general management activities. Like petitioner, Trott had no engineering training or background. In 1963, Trott retired from Procter & Gamble after 22½ years of service. Upon his retirement, Trott purchased a 25 percent interest in Crossbow, Inc. ("Crossbow"), a corporation which performed machine and fabricating work. In 1965, Trott became sole owner of Crossbow (Pet. App. 14-15).

At the time Trott first acquired an interest in Crossbow, the primary activity of the corporation was the manufacture and sale of a novelty item under the trade name "Drinklight" and the performance of job shop work for customers in the fabricating business (I-A. 55). The staff of that corporation was also experimenting with a telephone answering service. Thereafter, Trott conceived the idea of a tape recording device and a leaf or trash burner, both of which the Crossbow employees began developing. Models of the leaf or trash burner were constructed for the purpose of experimentation and development (Pet. App. 15).

In December 1965, Trott's patent counsel advised him that the leaf burner might have certain patentable features but suggested that the preparation of any patent application be delayed until after the completion of a prototype model. Two prototype models were thereafter constructed and tests performed upon them. In February 1966, the patent counsel advised petitioner that the tests performed upon the two existing models and his examination of them demonstrated that neither model performed satisfactorily enough to be marketable. He stated that the device would have to be modified before it could achieve an adequate level of performance. As a result, the patent counsel concluded at that time that "the leaf burner invention has not yet been reduced to practice" (Pet. App. 18-20; I-A. 103).

In February or March 1966, petitioner orally agreed to join in a limited partnership venture to assist Trott in financing the development of the device. On July 8, 1966, an agreement to form a limited partnership known as Burns Investment Company was executed. Under the partnership agreement, petitioner contributed $10,000 for a four percent limited partnership interest, and two other investors contributed $20,000 and $10,000 for eight and four percent limited partnership interests, respectively. Trott received a 50 percent interest as the sole general partner and a 34 percent interest as a limited partner, in exchange for which he contributed "[a]ll right, title and interest to a product concept" of the proposed device (Pet. App. 20-21).

As the general partner, Trott had the sole right to manage and conduct the partnership business (Pet. App. 21). Unless authorized by Trott, no limited partner could transact partnership business or act as agent for the partnership. The general partner had complete control of the funds of the partnership and their disbursement (I-A. 85). The limited partners' liability for partnership debts could not exceed their capital contribution (Pet. App. 21-22; I-A. 85).

During 1966, the Burns Investment Company partnership expended $36,780.44 for engineering services performed primarily by Crossbow employees and for management services performed exclusively by Trott. There was no written contract between Crossbow and Burns Investment Company for these services (Pet. App. 22-23; I-A. 56-57).

The office of Burns Investment Company was designated to be at the premises of Crossbow. In 1966, the Burns partnership had no manufacturing plant of its own, and had no office or separate facility. At the Crossbow shop, the Burns partnership had no telephone and there was no sign on the building denoting its presence. Neither petitioner Trott nor anyone else made any marketing efforts on behalf of the Burns partnership in 1966 (Pet. App. 23; I-A. 61).

After the $40,000 cash contribution by the limited partners had been exhausted, Trott financed the project on his own and radically changed the mechanical approach of the device. On June 10, 1968, Trott filed an application for a patent which was issued to him on March 3, 1970. Prior to that time, a cor-

poration was organized under the name Burns Investment Corporation to produce and market the device (Pet. App. 23; I-A. 68).

Burns Investment Company was not the only limited partnership formed by Trott for the financing of a potential invention. In 1965, Trott had formed two different limited partnerships, Echo Development Company and Courier Enterprises, for the respective development of the telephone answering device and the tape repording device (Pet. App. 15-18). As in the case of Burns Investment Company, the site of both Echo and Courier was the premises occupied by Crossbow (Pet. App. 15, 21). In 1965, petitioner contributed $21,325 and $5,000 respectively to Echo and Courier in exchange for 10 percent limited partnership interests (Pet. App. 16; II-A. 141, 146, 150, 155).

During the years 1965 through 1967, neither Echo nor Courier earned any income from operations. For 1965, their first year of existence, Echo and Courier elected to deduct their expenditures for research and development as current expenses under Section 174 of the Code. As a result, Echo and Courier reported losses for 1965 of $79,167.60 and $19,677.11, respectively (II-A. 138, 152). Unlike Crossbow's relationship with the Burns partnership, which was not reduced to a written understanding, the amounts Echo and Courier paid to Crossbow were pursuant to written contracts (I-A. 57).

Petitioner's pro rata share of the Echo and Courier partnership losses was $7,916.76 and $1,967.71, re-

spectively (II-A. 141, 155). For 1966, Echo and Courier reported smaller losses of $5,628.94 and $15.44 respectively (II-A. 143, 157). Petitioner's pro rata shares of these losses was $562.89 and $1.54, respectively (II-A. 146, 159). For 1967, Echo and Courier reported no income and no expenses (II-A. 148, 161).

Burns Investment Company's income and expenditures followed much the same pattern as that of Echo and Courier except that the principal amount of its expenditures were incurred in 1966, one year later. For the period August 1, 1966 to December 31, 1966, Burns Investment Company reported no income and $36,780.44 of research and development expenditures. As a result of this expense, the partnership's opening capital of $40,000 was reduced to $3,219.56 as of December 31, 1966. The partnership return stated that the company "elects to expense in the current taxable year * * * research and development expenses pursuant to Section 174(a)" (Pet. App. 24; II-A. 124-125, 127-128). For the year 1967, Burns Investment Company reported no income and no expenses (Pet. App. 24; II-A. 129). Finally, for the year 1968, it reported no income, research and development expenses of $3,217.64, and a bank service expense of $1.92, thereby leaving no remaining assets (Pet. App. 24; II-A. 133-134).

During 1966, petitioner devoted a minimum of 50 hours per week to his duties as vice president of Procter & Gamble; three hours a week to a thoroughbred race horse operation which he owned; and one hour a week to a joint venture oil operation. He spent ap-

proximately one hour per week in meetings and conversations with respect to the project of each partnership—the telephone answering device, the tape recorder, and the trash or leaf burner. Some of the conversations took place by telephone, some at the premises of Crossbow, some at restaurants, and some at Trott's or petitioner's home. Petitioner witnessed tests of various models of the leaf burner and gave advice regarding marketing if it ever developed to the stage of being marketable (Pet. App. 26).

Petitioner deducted his pro rata share of Burns Investment Company's 1966 loss of $9,195.11 on his individual income tax return for 1966 [3] (II-A. 116). On audit, the Commissioner of Internal Revenue disallowed the deduction on the ground that the research the development expenditures were not "incurred by him during the taxable year in connection with his trade or business" as required by Section 174(a)(1) (Pet. App. 27). The Tax Court found that Burns Investment Company was not engaged in a trade or

[3] In general, Section 704(a) of the Code permits a partner's distributive share of gains and losses to be determined by the partnership agreement. Although petitioner only had a 4 percent interest in profits, he deducted 25 percent of the partnership loss for 1966, pursuant to an amendment of the partnership agreement executed on April 3, 1967. The amendment provided that the limited partners were to share net partnership losses in proportion to their capital contributions (I-A. 87-89). Pursuant to Section 761(c) of the Code, the April 3, 1967 amendment to the partnership agreement was timely because it was made prior to April 15, 1967, the prescribed time for filing the 1966 partnership return. See Sections 6031 and 6072 of the Code.

business in 1966. It thereby upheld the Commissioner's determination that the expenses for research and experimentation upon the trash burning device paid by Burns Investment Company were not paid or incurred in connection with the trade or business of the partnership or of petitioner within the meaning of Section 174 (Pet. App. 26).

The court of appeals unanimously affirmed. It found that neither petitioner nor any other member of the Burns Investment Company held themselves out as engaging in the activity of selling the device in 1966. That court emphasized the fact that the partnership had nothing to sell during that year because the device did not even function properly at that time. As a result, it concluded that the partnership's activities did not meet the classic definition of a "trade or business" and that its expenditures incurred in 1966 could not be deductible under Section 174 (Pet. App. 35-44).

SUMMARY OF ARGUMENT

A

Section 174(a) of the Internal Revenue Code of 1954 allows a taxpayer to "treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account." Section 174(b) provides an option to amortize such expenditures over a period of not less than 60 months. Prior to the enactment of this statute in 1954, the courts had uni-

formly held that research or experimental expenditures were nondeductible capital outlays because the benefits derived from them extended beyond the taxable year. As a result, they could not be deducted under the longstanding provision, now contained in Section 162(a), allowing deductions for "all the ordinary and necessary expenses paid * * * in carrying on any trade or business."

The elimination in Section 174 of the requirement that research or experimental expenditures be "ordinary" insured their deductibility even if they were unusual or otherwise were deemed to be a capital expenditure. However, the statute retained the requirement, present in the business expense provision as well, that such expenditures be incurred in connection with a "trade or business." By incorporating in Section 174 a term which this Court has described as "not new to the tax laws," Congress made clear that not all research or experimental expenditures would be deductible, regardless of the context in which they were incurred.

B

The issue in this case is whether petitioner's partnership incurred research or experimental expenditures in 1966 "in connection with [its] trade or business" so as to be deductible under Section 174. Both courts below denied the claimed Section 174 deduction on the ground that no trade or business existed during that year. Their conclusion is in conformity with the classic definition of "trade or business," which is restricted to "holding one's self out to others as en-

gaged in the selling of goods or services." *Deputy* v. *duPont*, 308 U.S. 488, 499. Since that definition was formulated more than three decades ago, it has been applied by the courts in a wide variety of factual and statutory contexts. A necessary corollary of this definition of "trade or business" is that expenditures incurred in preparation for the possibility of entering a new trade or business are not deductible as "trade or business" expenses.

Although petitioner acknowledges that his partnership was not engaged in a "trade or business" as that term has been defined by the courts, he argues that all Section 174 requires is the existence of a profit motive. But if Congress had intended to allow the deduction of all research or experimental expenditures incurred in the hopes of realizing a profit, it surely would have employed the broader test in Section 212 permitting deduction of expenses incurred for the "production of income" rather than the narrower "trade or business" formulation. Moreover, this Court and others have recognized that the term "trade or business" has a uniform meaning throughout the Code. Petitioner's attempt to insulate the phrase "trade or business" in Section 174 from its use in other sections of the Code ignores both the decisions of this Court and the legislative history of that provision, which links it with the general "trade or business" expense deduction provision of Section 162(a).

C

Application of the foregoing principles to the facts of this case shows that the expenditures incurred by

petitioner's partnership in 1966 to develop a trash burner invention were not "incurred in connection with a trade or business" within the meaning of Section 174. During that year, neither petitioner nor any other member of the partnership held themselves out as engaging in the activity of selling anything. Indeed, the partnership had nothing whatever to sell because the invention was still in the development stage and did not even function properly. Under these circumstances, the activities of petitioner and his partnership did not satisfy the elements of the well-established "trade or business" definition. They were at best an investigation into the future marketing of a trash burning device. Since the expenditures were not incurred in connection with an existing trade or business, they were therefore not deductible under Section 174.

With one possible exception, the decision below is consistent with all the reported cases under Section 174. The courts have construed the "trade or business" nexus of Section 174 to require a showing of an existing trade or business, which is completely lacking in this case. To the extent that *Cleveland* v. *Commissioner*, 297 F.2d 169 (C.A. 4), is regarded as holding that the simple execution of a partnership agreement is sufficient to establish a "trade or business" for purposes of Section 174, we believe that its conclusion was properly rejected as erroneous by the court of appeals.

ARGUMENT

BOTH COURTS BELOW CORRECTLY HELD THAT PETITIONER COULD NOT DEDUCT HIS PRO RATA SHARE OF EXPENDITURES INCURRED BY A PARTNERSHIP FOR THE DEVELOPMENT OF AN INVENTION AS RESEARCH AND EXPERIMENTAL EXPENDITURES UNDER SECTION 174 OF THE CODE, BECAUSE THEY WERE NOT INCURRED IN CONNECTION WITH A TRADE OR BUSINESS

A. Introduction: The Background and Scope of Section 174

1. Prior to the enactment in 1954 of Section 174 of the Internal Revenue Code, the tax treatment of research or experimental expenditures incurred by a business was uncertain. Under the longstanding general business expense provision now in Section 162(a) of the Code, a deduction is allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."[4] While research or experimental expenditures might qualify as "necessary" in that they are "appropriate and helpful" for "the

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[4] The Revenue Act of 1913 allowed a deduction for the "ordinary and necessary" business expenses of a corporation and the "necessary" business expenses of an individual. Revenue Act of 1913, c. 16, 38 Stat. 114, 166, Secs. II (G) (b) (corporation) and Sec. II (B) (individuals). Five years later, the word "ordinary" was added to the section covering individuals' deductions. Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 214(a) (1). It appears that this change was designed merely to make the language of the two sections consistent. H. Rep. No. 767, 65th Cong., 2d Sess, p. 10; 4 Mertens, *Law of Federal Income Taxation,* § 25.01, n. 2 (1960 Rev.).

development of the [taxpayer's] business," *Welch* v. *Helvering*, 290 U.S. 111, 113, it was less clear that they would be deemed "ordinary."

Decisions of this Court have indicated that the statutory term "ordinary" serves two distinct purposes. In construing that term, the Court first observed that the word has the connotation of "normal, usual, or customary." *Deputy* v. *duPont*, 308 U.S. 488, 495. While noting that "an expense may be ordinary though it happen but once in the taxpayer's lifetime," the Court has defined "ordinary" to require that "the transaction which gives rise to [the expenditure] * * * be of common or frequent occurrence in the type of business involved." (*Ibid.*) See also *Welch* v. *Helvering*, *supra*, at 114. More recently, in *Commissioner* v. *Tellier*, 383 U.S. 687, the Court stated (383 U.S. at 689-690):

> The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.

See also *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345, 353.

The essence of an "ordinary" business expense as that term is used in *Commissioner* v. *Tellier*, *supra*, is that the benefit from the expense is derived and exhausted within the taxable year. In contrast, Section 263(a)(1) prohibits a deduction for "[a]ny amount

paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

While the principle embodied in this statutory provision is most frequently applied to costs incurred in the acquisition of a capital asset, *Woodward* v. *Commissioner*, 397 U.S. 572, 575, a cost that "results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year * * * " is also a nondeductible capital outlay. Treasury Regulations, Section 1.461-1(a)(1) and (2). See also *United States* v. *Akin*, 248 F.2d 742, 744 (C.A. 10); *Wells-Lee* v. *Commissioner*, 360 F.2d 665 (C.A. 8); *Teitelbaum* v. *Commissioner*, 294 F.2d 541 (C.A. 7), certiorari denied, 368 U.S. 987; *Darlington-Hartsville Coca-Cola B. Co.* v. *United States*, 273 F. Supp. 229, 231 (D.S.C.), affirmed, 393 F.2d 494, 496 (C.A. 4), certiorari denied, 393 U.S. 962.

The nondeductibility of so-called capital expenditures has been well established in the federal tax system from its very beginnings.[5] As a result, research

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[5] The language of Section 263 of the 1954 Code was first used in Section II(B) of the Revenue Act of 1913, c. 16, 38 Stat. 114, 167, and has been included in each successive income tax statute. See Sec. 5(a)(8), Revenue Act of 1916, c. 463, 39 Stat. 756, 759; Sec. 215(a)(2), Revenue Act of 1921, c. 136, 42 Stat. 227, 242; Sec. 215(a)(2), Revenue Act of 1924, c. 234, 43 Stat. 253, 271; Sec. 215(a)(2), Revenue Act of 1926, c. 27, 44 Stat. 9, 28; Sec. 24 (a)(2), Revenue Act of 1928, c. 852, 45 Stat. 791, 802; Sec. 24(a)(2), Revenue Act of 1932, c. 209, 47 Stat. 169, 183; Sec. 24(a)(2), Revenue Act of 1934, c. 277, 48 Stat. 680, 691; Sec. 24(a)(2), Revenue Act of 1936, c. 690, 49 Stat. 1648, 1662; Internal Revenue Code of 1939, Sec. 24(a)

or experimental costs incurred in the development of a new process, formula, or invention, the benefits of which would be derived beyond the year of the expenditure, were first regarded as nondeductibe capital outlays. Such costs could be only recovered by depreciation or amortization. Because of the difficulty in determining the useful life of such an asset or when a research project was abandoned so that a loss could be claimed, the Commissioner issued regulations in 1919 under the depreciation provisions allowing a taxpayer the option of either currently deducting or of depreciating "expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product * * *." Regulations 45, 62 and 65, Article 168.

The Regulation, however, was apparently deemed not to apply to the costs of acquiring a patent, which were early held to be nondeductible capital expenditures.[6] In 1926, the Regulation was withdrawn and the courts continued to hold a wide variety of research or experimental expenditures to be nondeductible.[7] Indeed, in *Red Star Yeast & Products Co.* v.

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(2) (26 U.S.C. 1952 ed.). An application of the bar against deduction of capital expenditures is at issue and is awaiting decision this Term in *Commissioner* v. *Idaho Power Co.*, No. 73-263.

[6] *Gilliam Manufacturing Co.* v. *Commissioner*, 1 B.T.A. 967; *Goodell-Pratt Co.* v. *Commissioner*, 3 B.T.A. 30; *Beaumont Co.* v. *Commissioner*, 3 B.T.A. 822.

[7] *Canning* v. *Commissioner*, 29 B.T.A. 99; *Hazeltine Corp.* v. *Commissioner*, 32 B.T.A. 110; *Claude Neon Lights, Inc.* v.

Commissioner, 25 T.C. 321, the Tax Court adhered to its prior decisions holding research and experimental expenditures nondeductible under the 1939 Code, notwithstanding the statement of the Commissioner of Internal Revenue before the Joint Committee on Internal Revenue Taxation on April 4, 1952, that such costs were deductible if the taxpayer had adopted the practice of charging them to expenses under its established method of accounting (25 T.C. at 341-342; CCH Standard Federal Tax Reports, Vol. 5, ¶ 6170 (1952 ed.)).

2. It was against this background that Section 174 was added to the statute as part of the 1954 codification. The parallels to the earlier short-lived Regulation outstanding from 1919 to 1926 are striking. Both provide the option of either currently deducting research or experimental expenditures or amortizing them. The Regulation's requirement that such expenditures be "in [the taxpayer's] business" was carried over in the statutory phrase in Section 174(a)(1) that the outlays be "research or experimental expenditures which are paid or incurred by [the taxpayer] during the taxable year in connection with his trade or business." Section 174 (b), which provides an option to amortize such expenditures ratably over no less than a 60-month period, likewise requires

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Commissioner, 35 B.T.A. 424; *Addressograph-Multigraph Corp.* v. *Commissioner,* 4 T.C.M. 147; *Dempster Mill Mfg. Co.* v. *Burnet,* 46 F. 2d 604 (C.A. D.C.); *Hart-Bartlett-Sturtevant Grain Co.* v. *Commissioner,* 12 T.C. 760, affirmed, 182 F. 2d 153 (C.A. 8).

that they be paid "in connection with [the taxpayer's] trade or business." Section 174 (b)(1)(A).[8]

The common requirement in the early Regulation and Section 174 that deductible research or experimental expenditures be incurred in connection with the taxpayer's trade or business indicates that Section 174 was not intended to allow the deduction of all research or experimental expenditures. To the contrary, it has a far more limited scope. The trade or business nexus of Section 174 must be viewed in the context of two other provisions: (1) the general business expense provision of Section 162(a), which allows a deduction for "ordinary and necessary expenses paid * * * in carrying on any trade or business"; and (2) the general bar in Section 263 against the deduction of capital expenditures.

Formulation of the "trade or business" standard in Section 174 without the requirement that the expenditure be "ordinary" demonstrates that the provision was simply intended to permit current deduction of research or experimental expenditures incurred by a business without a showing that the benefits from

[8] The only difference between the earlier Regulation and Section 174 is the latter's elimination of the necessity to determine useful life under the amortization option. Because the Regulation permitted depreciation of such costs, such treatment was available only if the research resulted in the creation of an asset with an ascertainable useful life. Section 174(b), however, specifically rests upon the unavailability of the deduction for depreciation. Section 174(b)(1)(C). It is thereby available to the class of research expenditures which do not result in the creation of specific assets with determinable useful lives.

them were derived and exhausted within a single taxable year. That Section 174 was intended to protect such costs expended by a business from classification as nondeductible capital expenditures is demonstrated by the statement in the statute that such outlays be treated as "expenses which are not chargeable to capital account." Furthermore, the simultaneous enactment in 1954 of an exception to the rule of Section 263 for "research and experimental expenditures deductible under section 174" confirms that this was the legislative purpose. Section 263(a)(1)(B). See also H. Rep. No. 1337, 83d Cong., 2d Sess., p. A65; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 225.[9]

This interpretation of the limited scope of the statute is supported by the legislative history. As the Senate Finance Committee observed with respect to this provision (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 33):

> No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in

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[9] To the extent that the election is made to amortize such expenditures, there would be an upward basis adjustment for an expenditure properly chargeable to capital account under Section 1016(a)(1). As the deferred expenses are deducted, there would be corresponding downward basis adjustments under Section 1016(a)(14). See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 215.

connection with abandoned projects, and recovery through amortization is provided where the useful life of these capital items is determinable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures.

To eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the House and your committee's bill provide that these expenditures, incurred subsequent to December 31, 1953, may, at the option of the taxpayer, be treated as deductible expenses. It also provides that a taxpayer may elect to capitalize such expenditures and if no other means of amortization is provided, may write them off over a period of not less than 60 months, beginning with the month in which benefits are first realized.

* * * *

See also H. Rep. No. 1337, 83d Cong., 2d Sess., p. 28.

Moreover, the elimination of the word "ordinary" in Section 174 also removed the necessity of a showing that a research or experimental expenditure was "of common or frequent occurrence in the type of business involved" under the first definition of that term adopted by the Court in *Deputy* v. *du Pont*, *supra*, 308 U.S. at 495. As a result, deductibility under Section 174 was not defendent upon the existence of a continuous program of research or experimentation under a regular budget which might be maintained only by large businesses. The provision thereby insures that small businesses as well can take ad-

vantage of the option to deduct or amortize such expenditures even if the outlays are infrequent or unusual.[10]

Under the statute, however, the expenditure must be incurred in connection with an existing "trade or business" of the taxpayer, whether large or small. This requirement—at issue in this case—is reaffirmed in the detailed discussion in the committee reports of the technical provisions of the statute, H. Rep. No. 1337, *supra*, pp. A57-A59; S. Rep. No. 1622, *supra*, pp. 214-216, as well as the case law. See, *e.g.*, *Stanton* v. *Commissioner*, 399 F. 2d 326 (C.A. 5); *Mayrath* v. *Commissioner*, 357 F. 2d 209 (C.A. 5), affirming 41 T.C. 582; and *Koons* v. *Commissioner*, 35 T.C. 1092.

3. The foregoing discussion of the terms and background of Section 174 demonstrates that Congress did not intend to allow deductions for research or experimental expenditures regardless of the context in which they were incurred. Such expenditures are deductible only if they arise in connection with the taxpayer's "trade or business." Contrary to the position of petitioner and the *amici*, this phrase—"trade or business"—cannot be interpreted in a vacuum without references to the other statutory provisions employing the "trade or business" standard.

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[10] See Statement of Under Secretary of the Treasury Marion B. Folsom, 1 Senate Hearings Before the Committee on Finance on the Internal Revenue Code of 1954, 83d Cong., 2d Sess., p. 123; Statement of Congressman Reed, 100 Cong. Rec. 3425; Statement of Congressman Knox, 100 Cong. Rec. 3553; and Statement of Senator Millikin, 100 Cong. Rec. 8998.

Thus, for example, in *Whipple* v. *Commissioner*, 373 U.S. 193, the question presented was whether a loss was sustained from the worthlessness of a debt "incurred in the taxpayer's trade or business" within the meaning of Section 23(k)(4) of the 1939 Code. Nevertheless, the starting point of the Court's analysis was a detailed review of its prior decisions interpreting the phrase "trade or business" as it appeared in the general business expense deduction provision. It noted that "[t]he concept of engaging in a trade or business as distinguished from other activities pursued for profit is not new to the tax laws" (373 U.S. at 197).

Similarly, here, both courts below appraised the facts of this case in the light of the long-standing judicial definition of the statutory term "trade or business." They concluded that neither petitioner nor the Burns Investment Company partnership were engaged in a trade or business with respect to the trash burning device because neither petitioner nor any other member of the partnership held themselves out as engaged in the activity of selling. An examination of the scope of the statutory term "trade or business," to which we now turn, confirms the correctness of that ruling.

B. The federal tax concept of "trade or business" requires engaging in the selling of goods or services and thereby precludes deductions under Section 174 for expenditures incurred simply in the hope of realizing a profit

1(a). From almost the very inception of the federal income tax, the statute has drawn a distinction between the broad range of income or profit producing activities and those which fit within the narrow category of trade or business. Thus, in the Revenue Act of 1916, Section 5(a) provided a deduction for those losses incurred in "business and trade" and those sustained "[i]n transactions entered into for profit but not connected with * * * business or trade." The distinction continues to exist in the present Code, which variously employs the terms "trade or business," "transaction entered into for profit," and "production of income" in a variety of contexts. See Appendix B, *infra*, pp. 43-44.[11]

The longstanding statutory distinction between a "trade or business" and other activities simply undertaken for the purpose of profit has been viewed by this Court as a fundamental differentiation between "business" activities and "investment" activities. Although the term "trade or business" is used throughout the Code, it is nowhere defined, either in the statute or the regulations, other than to include the performance of the functions of a public office. See Section 7701(a)(26) of the Code.

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[11] A list of the provisions of the Code employing these three phrases are set forth in Appendix B, *infra*, pp. 43-44.

Significantly, for purposes of this case, a "trade or business" has been defined by members of this Court as activity which "involves holding one's self out to others as engaged in the selling of goods or services." *Deputy* v. *du Pont, supra*, 308 U.S. at 499 (concurring opinion of Justice Frankfurter in which Justice Reed joined). Since the formulation of this classic definition more than three decades ago, it has been applied by the courts in considering whether a wide variety of activities constitutes a "trade or business" under several different provisions of the revenue statutes. *E.g.*, *White's Will* v. *Commissioner*, 119 F. 2d 619, 621 (C.A. 3) (trustee's activities of supervising investments); *Helvering* v. *Highland*, 124 F. 2d 556, 561 (C.A. 4) (executor's estate management activities); *Daily Journal Co.* v. *Commissioner*, 135 F. 2d 687, 688 (C.A. 9) (management of newspaper); *Trent* v. *Commissioner*, 291 F. 2d 669, 670-671 (C.A. 2) (services to employer); *McDowell* v. *Ribicoff*, 292 F. 2d 174, 176-177 (C.A. 3), certiorari denied, 368 U.S. 919 (fiduciary's estate management activities); *Richmond Television Corp.* v. *United States*, 345 F. 2d 901, 907 n. 7 (C.A. 4), vacated and remanded *per curiam* on other grounds, 382 U.S. 68 (pre-operating expenses to train prospective staff); and *Stanton* v. *Commissioner*, 399 F. 2d 326, 329 (C.A. 5) (development of invention).

This accepted definition of the term "trade or business" contains two separate elements. First, it requires that the taxpayer hold himself out to others as so engaged. Second, it is essential that the par-

ticular activity involve "selling," either of goods or services. Thus conceived, the category of "trade or business" may embrace such diverse enterprises as the sale of services by a lawyer or an employee, the sale of a novel, or even of an idea. The point we emphasize is that the element of "sale" is an indispensable feature of all of these transactions and the means by which profit is realized.[12]

(b). Consistent with this definition, the Court subsequently held in *Higgins* v. *Commissioner*, 312 U.S. 212, that a taxpayer's handling and oversight of his own extensive stock and bond investments was not a "trade or business" for purposes of the business expense deduction. Such personal investment activities did not involve the taxpayer's holding himself out as engaged in the selling of goods or services. This was the case even though the taxpayer was engaged in continuous personal activity with respect to his investments which involved the full time operation of an office and staff. In *Higgins*, the Court expressly rejected a broad interpretation of the term "trade or business" which would embrace everything about which a person can be employed. Cf. *Flint* v. *Stone Tracy Co.*, 220 U.S. 107, 171. Instead, it held that the existence of a "trade or business" would depend

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[12] The case law has developed other criteria for the existence of a "trade or business." For example, the activity must be frequent, continuous, and regular and the participants must devote a substantial part of their time to its pursuit. See, *e.g., Austin* v. *Commissioner*, 298 F. 2d 583 (C.A. 2); *Wright* v. *Commissioner*, 274 F. 2d 883 (C.A. 6); *Miller* v. *Commissioner*, 102 F. 2d 476 (C.A. 9).

upon the facts of each case as found by the trial court (312 U.S. at 217-218). See also *United States* v. *Pyne*, 313 U.S. 127, 129-131.

In response to the *Higgins* decision, Congress enacted Section 121(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, 819, which added Section 23(a)(2) to the 1939 Code (Section 212 of the 1954 Code). This provision authorized for the first time the deduction of "non-trade" or "non-business" expenses, *i.e.*, those incurred in the "production or collection of income, or for the management, conservation, or maintenance of property held for the production of income." It is significant that in making such expenses deductible, Congress did not see fit to broaden the existing concept of trade or business, which had been restrictively interpreted in *Higgins* and which continued to be an important concept for purposes such as Section 174, the provision involved here.

Instead, it created a new category of income-producing activity. Indeed, the committee reports underscore the lack of any intent to alter the trade-or-business concept by pointing out that the amendment would allow deductions "whether or not such expenses are paid or incurred in carrying on a trade or business." See S. Rep. No. 1631, 77th Cong., 2d Sess., p. 87; H. Rep. No. 2333, 77th Cong., 2d Sess., p. 74. As Justice Frankfurter noted in his plurality opinion in *McDonald* v. *Commissioner*, 323 U.S. 57, 62 (in which Chief Justice Stone and Justices Roberts and Jackson joined), "The amendment of 1942 merely enlarged the category of incomes with reference to which expenses

were deductible. It did not enlarge the range of allowable deductions of 'business' expenses." See also *United States* v. *Gilmore*, 372 U.S. 39, 45.

2. In view of the "trade or business" requirement in Section 174, deductibility under that provision does not simply depend, as petitioner argues (Br. 12-15), upon the existence of a profit motive. To be sure, the absence of a profit motive may defeat a claim that an activity is a trade or business.[13] But, as the Court

[13] The absence of a profit motive is especially significant in disallowing so-called "hobby losses." See, *e.g.*, *Porter* v. *Commissioner*, 437 F. 2d 39 (C.A. 2), affirming *per curiam*, 28 T.C.M. 1489; *Bessenyey* v. *Commissioner*, 379 F. 2d 252 (C.A. 2), certiorari denied, 389 U.S. 931; *Yanow* v. *Commissioner*, 358 F. 2d 743 (C.A. 3), affirming *per curiam*, 44 T.C. 444; *Lamont* v. *Commissioner*, 339 F. 2d 377 (C.A. 2); *Hirsch* v. *Commissioner*, 315 F. 2d 731 (C.A. 9).

The *amici curiae* argue (Br. 8-9) that the purpose of Section 174 would be better served if the criteria under Section 183 were employed. That provision sets forth rules relating to the allowance of deductions for activities "not engaged in for profit" and essentially codifies the court-made law with respect to hobby losses. Unlike Section 174, the purpose of Section 183 is to provide rules for the disallowance of deductions with respect to expenses which are not allowable as trade or business expenses (Section 162) or as expenses incurred for the production of income (Section 212). The thrust of Section 183 is to provide objective rules for the determination whether an activity is engaged in for profit. It does not, however, purport to eliminate the bar against the deduction of the type of capital expenditures incurred by petitioner. If such expenditures are to be deductible, they must qualify under Section 174. Any importation of the criteria of Section 183 into Section 174, which is adressed to an entirely different problem, must be accomplished, if at all, by Congress.

reaffirmed in *Whipple* v. *Commissioner, supra,* a profit motive cannot of itself establish a trade or business.

If Congress had intended that all research or experimental expenditures were to be deductible whenever they were incurred in the hope of realizing a profit, Section 174 would have employed the broader "production of income" test of Section 212 rather than the more restrictive "trade or business" standard. Indeed, had Congress done so, research or experimental expenditures would be deductible with little regard to the seriousness of purpose with which they were incurred. Petitioner's argument simply ignores the plainly stated requirement of Section 174 that the expense be incurred "in connection with [the taxpayer's] trade or business."

Faced with the language of the statute and the well-established definition of the phrase "trade or business," petitioner concedes (Br. 13) that his partnership was not engaged in a "trade or business" as that term has been defined by the courts. He contends, however, that this term as used in Section 174 connotes a broader range of profitmaking activities, urging that the judicial definition of "trade or business" is relevant only with respect to those statutory provisions previously construed by the courts.

This argument, as we have noted, is contrary to the Court's analysis in *Whipple* v. *Commissioner, supra,* which looked not only to the Court's own prior decisions under the business expense provisions but

also to the Congressional response in 1942 to *Higgins*. In *Whipple*, the Court held that the meaning of "trade or business" under the bad debt provisions was identical to its meaning under the statutory allowance of a deduction for general "trade or business" expenses. The uniform meaning of the term throughout the Code is underscored by the Court's rejection of the taxpayer's claim in *Whipple* "against the background of the 1942 amendments and the decisions of this Court in the *Dalton*, *Burnet*, *du Pont* and *Higgins* cases * * * " (373 U.S. at 202). See also *Cooper Tire & Rubber Co. Employees' Retirement Fund* v. *Commissioner*, 36 T.C. 96, 100, affirmed *per curiam*, 306 F. 2d 20 (C.A. 6).[14]

Finally, petitioner's attempt to accord a unique definition to the phrase "trade or business" in Section 174 is expressly refuted by the legislative history (*supra*, pp. 19-20), which makes specific reference to the "ordinary and necessary" standard of the general business expense deduction provision of Section 162(a). The elimination of the "ordinary and necessary" requirement and the retention of the "trade or business" standard further demonstrates that the meaning of "trade or business" in the two statutes

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[14] Petitioner suggests (Br. 16) that if the term "trade or business" in Section 174 had the same meaning as in Section 162(a), the former provision would have an explicit cross-reference to the latter. But the absence of such a cross-reference in the bad debt deduction provision involved in *Whipple* did not prevent the Court from invoking the meaning of "trade or business" as used in the predecessor of Section 162(a).

was intended to be identical.[15] To conclude otherwise would be to suggest that the congressional retention of the "trade or business" requirement in Section 174 was either inadvertent or that a phrase with a long-standing definition was to have a wholly different meaning in that provision. Neither possibility, we submit, offers a realistic interpretation of the statutory language. As Justice Frankfurter observed in

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[15] In support of his argument that Sections 162(a) and 174 have different standards, petitioner points (Br. 15-16) to the differing terminology of the two provisions. He notes that Section 162(a) uses the term "in carrying on any trade or business" while Section 174 speaks of expenses incurred "in connection with [the taxpayer's] trade or business." Petitioner thereby draws the conclusion that the language of the former provision is more consonant with the requirement of an existing business. Suffice it to say that there is no support in the legislative history to indicate that the phrases are to be accorded such a variant reading. Moreover, the Treasury Regulations under Section 162 frequently use the terms "connected with or pertaining to" and "in connection with"—phrases similar or identical to that of Section 174. See Treasury Regulations, Sections 1.162-1(a) and 1.162-17(a).

Finally, in reporting out the bill which added Section 23 (a)(2) to the 1939 Code (now Section 212 of the 1954 Code), the House Ways and Means Committee Report used the terms "in connection with" and "in carrying on" interchangeably. Thus, it stated (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 75):

> A deduction under this section is subject, except for the requirement of being *incurred in connection with* a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense *paid or incurred in carrying on* any trade or business. [Emphasis added.]

See also S. Rep. No. 1631, 77th Cong., 2d Sess., p. 88.

a similar context in *McDonald* v. *Commissioner*, *supra*, 323 U.S. at 64—

> [A]s a system, tax legislation is not to be treated as though it were loose talk or presented isolated abstract questions of law casting upon the federal courts the task of independent construction. Tax language normally has an enclosed meaning or has legitimately acquired such by the authority of those specially skilled in its application.

3. Since the accepted definition of the term "trade or business" requires holding one's self out as engaging in the activity of selling either goods or services, there is necessarily a time in the history of any enterprise organized for profit when that test may be satisfied. Conversely, the period of time in which preparations are made for the commencement of the business do not constitute engaging in a trade or business. This is a necessary corollary of the definition which requires a sufficient degree of affirmative action so that it can readily and objectively be ascertained that the enterprise has begun to function.

While the making of sales and the flow of gross receipts is a persuasive indicium of the existence of a trade or business, the absence of sales and gross receipts need not be determinative. For example, the opening of an office by a young lawyer and his holding himself out as ready to perform the services of his profession would presumably constitute engaging in a trade or business even though he may not receive any fees for a substantial period of time. The

costs incurred for overhead during this period would be deductible as trade or business expenses. However, the pre-operating expenses borne by the young lawyer in deciding where to locate his office would not be deductible. The dividing line is the point in time when the taxpayer begins to hold himself out as engaged in selling of goods or services.

Thus, the courts have uniformly held that outlays incurred in investigating a new trade or business or preparing for the possibility of entering it are non-deductible. See, *e.g.*, *Richmond Television Corp.* v. *United States*, 345 F. 2d 901, 907 (C.A. 4), vacated and remanded *per curiam* on other grounds, 382 U.S. 68; *Weinstein* v. *United States*, 420 F. 2d 700, 701 (Ct. Cl.); *Stanton* v. *Commissioner*, 399 F. 2d 326, 329 (C.A. 5); *Dean* v. *Commissioner*, 56 T.C. 895, 902-903; *Abegg* v. *Commissioner*, 50 T.C. 145, 154, affirmed on other grounds, 429 F. 2d 1209 (C.A. 2), certiorari denied *sub nom. Cresta Corp. S.A.* v. *Commissioner*, 400 U.S. 1008; *Walet* v. *Commissioner*, 31 T.C. 461, 471; *Frank* v. *Commissioner*, 20 T.C. 511, 514; *Westervelt* v. *Commissioner*, 8 T.C. 1248, 1254-1255. As the Fourth Circuit stated in *Richmond Television Corp.* v. *United States*, *supra*, 345 F. 2d at 907:

> [E]ven though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he still has not "engaged in carrying on any trade or business" within the intendment of section 162(a) until such time as the business has begun to

function as a going concern and performed those activities for which it was organized.

The Fourth Circuit indicated that this rule was equally applicable to claimed research or experimental expenditures under Section 174 by citing the cases in which Section 174 deductions were disallowed for lack of an existing trade or business. See 345 F. 2d at 907, n. 7.[16] Under both Sections 162(a) and 174, therefore, preparatory expenditures incurred prior to the commencement of the taxpayer's holding himself out as engaged in selling activities—the *sine qua non* of a "trade or business"—are not currently deductible. Their costs may be recovered, if at all, only through capitalization and depreciation.

We turn now to an examination of the facts of this case, which demonstrate that the activities of petitioner's partnership during 1966 were at most in

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[16] In arguing that he is entitled to current deductions under Section 174 in advance of the commencement of a trade or business by the Burns partnership, petitioner cites (Br. 8) the statement of Representative Camp in support of the argument that the provision was designed to help "small or beginning business enterprises." 97 Cong. Rec. A4326. Petitioner presumably infers that the settled line of decisions disallowing trade or business expense deductions have no application to outlays for research or experimental purposes. But the remarks of Representative Camp were made with respect to a wholly different bill introduced three years before the enactment of Section 174. Unlike the statute, that bill, which was proposed by the American Bar Association, had no requirement that such expenditures be incurred in connection with a trade or business. See H.R. 4775, 82d Cong., 1st Sess.; 75 Reports of the American Bar Association 130-132 (1950).

preparation for the possibility of entering a trade or business in the future.

C. The expenditures paid by the partnership to develop the invention prior to the time it was marketed were not incurred in connection with a trade or business

When the foregoing principles governing the definition of "trade or business" are applied to the facts of this case, it is plain that the expenditures paid by the partnership in 1966 were not deductible under Section 174. During that year, neither petitioner nor any other member of the partnership held themselves out as engaging in the activity of selling anything. In fact, the existence of the Burns partnership was unknown to the public (Pet. App. 23). Under no stretch of the imagination was there a going business in the accepted sense of that term.

Indeed, in 1966 the partnership had nothing whatsoever to sell because the invention was still in the development stage and did not even function properly.[17] In the opinion of the partnership's own patent

[17] Disputing the relevance of the fact that the partnership had no product to offer during the taxable year at issue, the *amici curiae* argued (Br. 12-13) that it is unjust to limit the availability of the benefits of Section 174 to those enterprises engaged in marketing of a product. It contends that the effect of such an interpretation would be to deny the deduction for pre-marketing research costs to an enterprise developing an initial product while allowing it to an enterprise which is engaged in marketing another product, no matter how tenuous the connection may be between the developed product and the marketed product. Disallowance of a Section 174 deduction for the development of an initial product is simply a consequence of the statutory requirement of an

counsel, the device "ha[d] not yet been reduced to practice" (I-A. 103). No patent was issued until 1970, four years later (Pet. App. 23). Under these circumstances, the activities of petitioner and his partnership were at most an investigation into the future possibility of marketing a trash burning device.

As such, the expenditures incurred prior to the marketing of the device fall into the category of preoperating investigatory outlays which the courts have consistently held nondeductible as "trade or business" expenses. There can therefore be no allowable deduction under a provision such as Section 174, which requires that the experimental expenditures be incurred "in connection with his trade or business."

Consistent with our view that Section 174 was intended simply to relieve research or experimental expenditures from the need to qualify under the "ordinary" standard of Section 162(a), the courts have construed the "trade or business" nexus of Section 174 to require a showing of an existing trade or business, which is completely lacking in this case. Thus, for example, in *Stanton* v. *Commissioner*, 399 F. 2d 326 (C.A. 5), the court held that the phrase

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existing "trade or business." However, the existence of a marketed product does not guarantee the availability of Section 174 treatment with respect to the development of another product. If the connection between the marketed product and the developed product is sufficiently tenuous, the Commissioner will disallow the claimed deduction. Compare *Mayrath* v. *Commissioner*, 41 T.C. 582, affirmed, 357 F. 2d 209 (C.A. 5), discussed *infra*, p. 36, with *Best Universal Lock Co.* v. *Commissioner*, 45 T.C. 1, discussed *infra*, p. 37 n. 18.

"trade or business" in Section 174 presupposes an existing trade or business of so as to exclude deductions for expenses incurred in the hope of realizing a profit or in preparation for the possibility of entering a new trade or business (399 F. 2d at 329). The court therefore denied a deduction under Section 174 for expenses incurred in attempting to invent a storm proof boat. See also *Koons* v. *Commissioner*, 35 T.C. 1092, 1100-1101.

Similarly, *Mayrath* v. *Commissioner*, 41 T.C. 582, affirmed, 357 F. 2d 209 (C.A. 5), denied a claimed Section 174 deduction for expenditures incurred in connection with the development of an experimental home. Despite the fact that the taxpayer was an inventor of farm implements, both courts found that the home was not built in the course of a trade or business. The Tax Court observed, in terms most appropriate to this case: "We think the statute was intended to be used in the realistic and practical sense of a *going* trade or business—a condition which does not exist here" (41 T.C. at 590) (Emphasis in original).[18]

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[18] To the same effect are *Downs* v. *Commissioner*, 49 T.C. 533; *Kilroy* v. *Commissioner*, 32 T.C.M. 27; *Cunningham* v. *Commissioner*, 27 T.C.M. 1219; *Scull* v. *Commissioner*, 23 T.C.M. 1353; and *Schafer* v. *Commissioner*, 23 T.C.M. 927. See also 4A Mertens, *Law of Federal Income Taxation*, Sec. 25.33, p. 169 (1972 ed.), which states: "It is clear that the statutory phrase 'trade or business' presupposes an existing business with which the taxpayer is directly connected. Expenditures made in investigating a potential new trade or

Indeed, the only reported decision relied upon by petitioner (Br. 16-17) that arguably supports his position is *Cleveland* v. *Commissioner*, 297 F. 2d 169 (C.A. 4). There, the taxpayer, a lawyer, had made extensive loans over a long period of time to an inventor who, for more than 10 years, had experimented with the invention of an inorganic liquid binding material and had applied for patents. After having made a number of advances, taxpayer entered into a trust agreement with the inventor regarding their respective interests in the compound. The Tax Court disallowed a deduction for the advances claimed under Section 174, holding that the arrangement constituted at most a sale by the inventor to the lawyer of a one-half interest in the invention in consideration of past monies advanced, and that the expendi-

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business, or preparatory to entering into such business, do not qualify for the application of Section 174(a)(1) of the Code."

Although petitioner (Br. 11) relies upon *Best Universal Lock Co.* v. *Commissioner*, 45 T.C. 1, *acq.* 1966-2 Cum. Bull. 4X, that case is distinguishable. There, the taxpayer, an existing business engaged in the manufacture and sale of locks, was permitted to deduct research and experimental expenditures incurred in the development of an isothermal air compressor. Based upon the corporation's long history of experimentation and efforts to develop new products, the Tax Court held that the expenditures at issue were "incurred in connection with [its] trade or business." Here, however, the Burns partnership's expenditures to develop the trash burner could not be linked to an existing trade or business because the partnership was not engaged in any trade or business. It was simply experimenting with a potential product that might become part of a future trade or business. Cf. Rev. Rul. 71-162, 1971-1 Cum. Bull. 97.

tures were not made in taxpayer's trade or business. The court of appeals, however, reversed and allowed the Section 174 deduction with respect to the post-agreement advances, characterizing the agreement as creating a joint venture which it held to be a "trade or business" of the taxpayer and the inventor.

The length of time over which the experimentation was conducted in *Cleveland* is significantly longer than in this case. But more importantly, unlike the subsequent decision of the Fourth Circuit in *Richmond Television Corp.* v. *United States, supra,*[19] the earlier *Cleveland* opinion of that court did not focus on the "trade or business" issue. It is therefore unclear what considerations led the *Cleveland* court to rule that a "trade or business" existed after the execution of the partnership agreement. As we have demonstrated, however, it is the performance of the specific activity of holding oneself out as selling which constitutes engaging in a trade or business. That factor was absent both here and in *Cleveland.*

Thus, to the extent that *Cleveland* is regarded as holding that the simple execution of a partnership agreement, without more, transforms non-deductible research and development expenditures into qualifying outlays under Section 174, we believe that such a conclusion was properly rejected as erroneous by the

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[19] As we have pointed out *supra*, p. 33, while *Richmond Television Corp.* dealt with a claimed deduction under Section 162(a), it correctly recognized that the "trade or business" standard under Section 174 is identical. See 345 F. 2d at 907 n. 7.

court of appeals (Pet. App. 40). Indeed, in the light of the Fourth Circuit's subsequent ruling in *Richmond Television Corp.* v. *United States*, *supra*, it is doubtful whether that court would follow its prior *Cleveland* decision.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APRIL 1974.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 174. RESEARCH AND EXPERIMENTAL EXPENDITURES.

(a) *Treatment As Expenses.*—

(1) *In general.*—A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

(2) *When method may be adopted.*—

(A) *Without consent.*—A taxpayer may, without the consent of the Secretary or his delegate, adopt the method provided in this subsection for his first taxable year—

(i) which begins after December 31, 1953, and ends after the date on which this title is enacted, and

(ii) for which expenditures described in paragraph (1) are paid or incurred.

(B) *With consent.*—A taxpayer may, with the consent of the Secretary or his delegate, adopt at any time the method provided in this subsection.

(3) *Scope.*—The method adopted under this subsection shall apply to all expenditures described in paragraph (1). The method adopted shall be adhered to in computing taxable income for the taxable year and for all subsequent taxable

years unless, with the approval of the Secretary or his delegate, a change to a different method is authorized with respect to part or all of such expenditures.

(b) *Amortization of Certain Research and Experimental Expenditures.*—

(1) *In general.*—At the election of the taxpayer, made in accordance with regulations prescribed by the Secretary or his delegate, research or experimental expenditures which are—

(A) paid or incurred by the taxpayer in connection with his trade or business,

(B) not treated as expenses under subsection (a), and

(C) chargeable to capital account but not chargeable to property of a charcter which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion),

may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the taxpayer first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustments to basis of property).

(2) *Time for and scope of election.*—The election provided by paragraph (1) may be made for any taxable year beginning after December 31,

1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The method so elected, and the period selected by the taxpayer, shall be adhered to in computing taxable income for the taxable year for which the election is made and for all subsequent taxable years unless, with the approval of the Secretary or his delegate, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditure paid or incurred during any taxable year before the taxable year for which the taxpayer makes the election.

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APPENDIX B

I. *Substantive Provisions of the Internal Revenue Code Using the Phrase "Trade or Business"*

Sections 46(c)(3), 47(b), 48(i), 50A(c)(2)(B), 50B(c)(1), 57(b)(2), 62(1), 75(a), 103(c)(2), 108(a), 114(a), 116(d), 162(a), 163(d), 164(a), 165(c)1, 166(d)(2), 167(a)(1), 170(e)(1), 171(d), 172(d)(4), 174, 179(d)(1)(B), 182(d)(2)(A), 216(c), 217(f)(1)(B), 245(a), 264(a)(1), 268, 274(a)(1), 301(b)(1)(C), 311(d)(2)(B), 312(b)(2), 337(b)(1)(A), 341(b)(3)(B), 346(b), 355(b), 382(a)(1)(C), 401(c)(1), 404(a), 407(a), 421(a), 446(d), 455(c)(1), 456(c)(1), 471, 481(b)(4)(C), 502, 509(a)(2)((A)(ii), 512(a), 513, 514(b)(1), 543(a)(3), 545(b)(8), 556(b)(5), 702(a)(3), 707(c), 804(b)(3), 805(b)(4), 817(a), 822(b)(2), 832(c)(1), 842, 856(a)(4), 861(a)(1)(C) and (D), 864(b), 871(b), 872(a), 873, 875, 877(b), 881(a), 882(b), 884(2), 894(b), 904(f), 906, 911(b), 921, 931(a)(2), 934(b)(2), 952(b), 954(c)(3), 956(b)(2)(C), 957(c), 981(b)(2), 993(c), 996(g), 1031(a), 1033(g), 1054, 1221, 1231, 1236(a)(2), 1237(a), 1244(d)(3), 1253(d)(1), 1341(b)(2), 1402(c), 1441(c), 1442(b), 1451(a) and (b), and 3401(d)(2).

II. *Substantive Provisions of the Internal Revenue Code Using the Phrase "Production of Income"*

Sections 57(b)(2)(C), 62(5), 163(d)(3)(C), 164(a), 167(a)(2), 212(1) and (2), 216(c), 265(1) and 404(a).

III. *Substantive Provisions of the Internal Revenue Code Using the Term "Entered into for Profit"*

Sections 165(c)(2), 877(b), and 931(d)(2)(A).

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